



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

OFFICE OF  
CHIEF COUNSEL

Number: **INFO 2001-0135**

Release Date: 6/29/2001

UIL:852.02-00

May 4, 2001

[REDACTED]

Dear [REDACTED]:

This is in response to your letter to Commissioner Rossotti concerning a question about short-term capital gains distributed by mutual funds.

Your question relates to the federal tax status of a regulated investment company ("RIC"), which is sometimes referred to as a mutual fund. A RIC is actually a domestic corporation for federal tax purposes, not a pass-through entity such as a partnership.

In general, a distribution from a corporation is either a dividend or a return of capital. This is the case even where a distribution from a corporation might be attributed to a capital asset. For example, if a corporation sells a long-term asset, such as a piece of real estate, for a gain and then decides to distribute the gain to its shareholders, the shareholders receive a dividend, not a capital gain distribution. This is in contrast to a distribution from a partnership from a similar transaction, where the capital gain character of the transaction would pass through to the partner.

Generally, dividends paid by corporations are treated as ordinary income to the shareholder. In the case of a RIC, however, Congress granted special permission to pay dividends that are not ordinary dividends. In addition to an ordinary dividend, in certain cases a RIC may pay a capital gain dividend or an exempt-interest dividend. A RIC is required to send its shareholder a Form 1099-DIV or similar statement to tell the shareholder the kind of distribution he or she receives.

Section 852(b)(3) of the Internal Revenue Code limits the amount of a RIC's capital gain dividend to the mutual fund's net capital gain.

Section 1222(11) defines the term "net capital gain" as the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for that year.

Section 1222(7) defines the term “net long-term capital gain” as the excess of long-term capital gains for the taxable year over the long-term capital losses for that year.

Section 1222(6) defines the term “net short-term capital loss” as the excess of short-term capital losses over the short-term capital gains for that year.

If the RIC’s short-term capital gains exceed the short-term capital losses, this excess does not fall within the definition of net capital gain and cannot therefore be designated by the RIC as a capital gain dividend. Dividends not designated by the mutual fund as capital gain dividends (or as exempt-interest dividends) are ordinary dividends includible in income of the recipient as ordinary income.

We hope this information will be helpful. If we can be of any further assistance, please call Pamela Lew at (202) 622-3950.

Sincerely yours,  
Acting Associate Chief Counsel  
(Financial Institutions & Products)

By: \_\_\_\_\_  
Alice M. Bennett  
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